HSBC Global Research

28 May 2020

Essential Utilities (WTRG US)

Buy: Current challenges a catalyst for integration

Equities
Water Utilities

United States

- Challenges in US water – how Essential is responding
- Guidance intact; bond proxy status unaltered
- Maintain Buy rating and USD50 target price

Growth strategy: Essential Utilities has a 3-pronged growth strategy: A growing core water and wastewater business; opportunistic pursuit of large, regulated utility/infrastructure targets – the company delivered on this with the Peoples gas acquisition (recently completed) and the DELCORA waste water transaction, which is expected to complete regulatory approvals by 2022; and MBAs (Market Based Activities), which are probably going to be less of a priority given the current challenges.

COVID-19 challenges: We analyse the risks to Essential from COVID-19 – many of these are mitigated by its large residential customer base. During its Q1 earnings call, management explained that the Peoples acquisition had been completed on the day that the US went into COVID-19 lockdown. This was a catalyst for harmonising business practices across the two separate businesses, so corporate integration might be quicker than otherwise expected. Its 2020 guidance remains: 2020 EPS of USD1.53 to USD1.58, and 2019-22e earnings CAGR of 5% to 7%.

Bond proxy: Essential's share price has outperformed the S&P 500 by 1% since 1 January 2019. It is trading at a discount to its water peer group's 2020e PE, but in line with some of the US electricity utilities, according to Refinitiv Datastream. This reflects, in our view, its multi-utility status. The US Treasury 10-year yield has fallen sharply. WTRG, as a defensive utility, should be inversely correlated to bond yields.

Maintain Buy rating and target price of USD50: We value Essential Utilities via three methodologies: DCF, dividend yield, and the average of PE multiple and rate-based valuations: We now adopt a lower 2.5% risk-free rate (from 3.0%) set by our equity strategists and used for the other US utilities under our coverage. We maintain our equity risk premium and beta assumptions of 3% and 0.60, respectively. Our DCF valuation increases to USD50.0 (from USD41.1). In our PE multiple-based valuation, we maintain our target multiple in line with market peers, at 30.0x. We use an unchanged water peer group P/B of 2.4x as a proxy for a rate-base valuation. This is consistent with the US utilities under our coverage and a proxy for EV. The average of our PE and rate-based valuations adjusts to USD51.6 (from USD51.9). For our Yield-based valuation, we increase our target yield to 2.13% from 1.75%, in line with Water and Related Utilities peers. This results in a lower Yield-based valuation of USD47.5 (from USD57.8). Overall, these valuations lead to an unchanged TP of USD50.00, which implies 21.0% upside. Consequently, we maintain our Buy rating.

MAINTAIN BUY

TARGET PRICE (USD)	PREVIOUS TARGET (USD)
50.00	50.00

SHARE PRICE (USD)	UPSIDE/DOWNSIDE
41.31	+21.0%

(as of 26 May 2020)

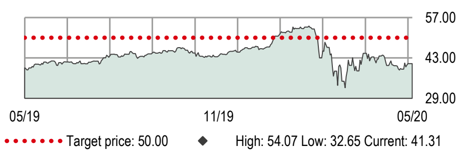
MARKET DATA

Market cap (USDm)	10,123	Free float	100%
Market cap (USDm)	10,123	BBG	WTRG US
3m ADTV (USDm)	59	RIC	WTRG.N

FINANCIALS AND RATIOS (USD)

Year to	12/2019a	12/2020e	12/2021e	12/2022e
HSBC EPS	1.04	1.55	1.67	1.79
HSBC EPS (prev)	1.04	1.56	1.68	1.81
Change (%)	0.0	-0.9	-0.2	-1.2
Consensus EPS	1.48	1.48	1.66	1.80
PE (x)	39.7	26.7	24.7	23.1
Dividend yield (%)	2.3	2.5	2.6	2.9
EV/EBITDA (x)	22.8	17.8	16.5	15.7
ROE (%)	7.6	8.3	7.5	7.6

52-WEEK PRICE (USD)



Source: Refinitiv IBES, HSBC estimates

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Financials & valuation: Essential Utilities

Buy

Financial statements

Year to	12/2019a	12/2020e	12/2021e	12/2022e
Profit & loss summary (USDm)				
Revenue	890	1,884	2,144	2,278
EBITDA	497	817	913	993
Depreciation & amortisation	-157	-239	-267	-292
Operating profit/EBIT	340	578	646	701
Net interest	-131	-150	-170	-192
PBT	212	428	476	509
HSBC PBT	209	428	476	509
Taxation	13	-34	-38	-41
Net profit	225	394	438	469
HSBC net profit	225	394	438	469
Cash flow summary (USDm)				
Cash flow from operations	339	702	723	770
Capex	-550	-950	-1,000	-1,000
Cash flow from investment	-605	-5,225	-1,277	-1,000
Dividends	-189	-257	-286	-309
Change in net debt	-1,352	3,191	540	539
FCF equity	-212	-248	-277	-230
Balance sheet summary (USDm)				
Intangible fixed assets	64	939	939	939
Tangible fixed assets	7,224	11,335	12,345	13,053
Current assets	2,011	2,152	2,189	2,208
Cash & others	1,869	1,869	1,869	1,869
Total assets	9,360	14,488	15,534	16,261
Operating liabilities	1,468	1,678	1,733	1,761
Gross debt	3,077	6,269	6,809	7,347
Net debt	1,208	4,400	4,940	5,478
Shareholders' funds	3,881	5,606	6,058	6,218
Invested capital	5,962	10,879	11,871	12,569

Ratio, growth and per share analysis

Year to	12/2019a	12/2020e	12/2021e	12/2022e
Y-o-y % change				
Revenue	6.2	111.8	13.8	6.3
EBITDA	5.7	64.4	11.8	8.8
Operating profit	5.3	69.9	11.8	8.4
PBT	18.6	102.4	11.2	7.0
HSBC EPS	-3.4	48.9	8.1	7.0
Ratios (%)				
Revenue/IC (x)	0.2	0.2	0.2	0.2
ROIC	6.4	6.3	5.2	5.3
ROE	7.6	8.3	7.5	7.6
ROA	4.1	4.5	4.0	4.1
EBITDA margin	55.9	43.4	42.6	43.6
Operating profit margin	38.2	30.7	30.2	30.8
EBITDA/net interest (x)	3.8	5.4	5.4	5.2
Net debt/equity	31.1	78.5	81.5	88.1
Net debt/EBITDA (x)	2.4	5.4	5.4	5.5
CF from operations/net debt	28.0	16.0	14.6	14.1
Per share data (USD)				
EPS Rep (diluted)	1.04	1.55	1.67	1.79
HSBC EPS (diluted)	1.04	1.55	1.67	1.79
DPS	0.94	1.01	1.09	1.18
Book value	17.97	22.04	23.15	23.76

Valuation data

Year to	12/2019a	12/2020e	12/2021e	12/2022e
EV/sales	12.7	7.7	7.0	6.8
EV/EBITDA	22.8	17.8	16.5	15.7
EV/IC	1.9	1.3	1.3	1.2
PE*	39.7	26.7	24.7	23.1
PB	2.3	1.9	1.8	1.7
FCF yield (%)	-2.1	-2.5	-2.7	-2.3
Dividend yield (%)	2.3	2.5	2.6	2.9

* Based on HSBC EPS (diluted)

ESG metrics

Environmental Indicators	12/2019a
GHG emission intensity*	n/a
Energy intensity*	n/a
CO_2 reduction policy	Yes
Social Indicators	**12/2019a**
Employee costs as % of revenues	n/a
Employee turnover (%)	n/a
Diversity policy	Yes

Governance Indicators	12/2019a
No. of board members	8
Average board tenure (years)	7.0
Female board members (%)	25
Board members independence (%)	87.5

Source: Company data, HSBC

* GHG intensity and energy intensity are measured in kg and kWh respectively against revenue in USD '000s

Issuer information

Share price (USD)	41.31
Target price (USD)	50.00
RIC (Equity)	WTRG.N
Bloomberg (Equity)	WTRG US
Market cap (USDm)	10,123

Free float	100%
Sector	Water Utilities
Country/Region	United States
Analyst	Verity Mitchell
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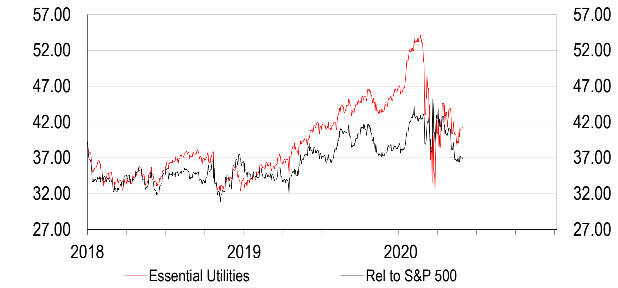
Price relative



Source: HSBC

Note: Priced at close of 26 May 2020

Current challenges a catalyst for integration

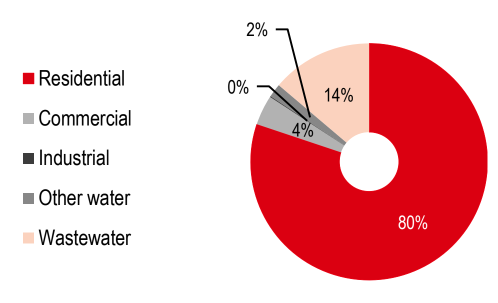
- Challenges in US water – how Essential is responding
- Guidance intact; bond proxy status unaltered
- Maintain Buy rating and USD50 target price

Investment summary: Three-pronged approach

Essential Utilities has core competencies in infrastructure investment (pipes and water production plant), regulatory affairs, and operations. Using these as pillars, Essential has created a 3- pronged growth strategy:

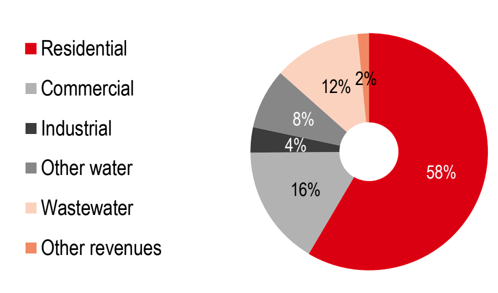
1. Municipal initiative: A growing core water and wastewater business - Aqua. This remains the primary focus for the company;
2. Strategic M&A: Opportunistic pursuit of large, regulated utility/infrastructure targets – the company delivered on this with the Peoples gas acquisition (recently completed) and the DELCORA waste water transaction, which is expected to complete regulatory approvals by 2022.
3. MBAs (Market Based Activities): Complementary to the regulated businesses. Capitalises on broader infrastructure renewals, but are probably going to be less of a priority given the current challenges.

Customer composition at FY2019



Source: Essential Utilities - company presentation data

Revenue composition at FY2019



Source: Essential Utilities - company presentation data

Quick integration

During its Q1 earnings call, management explained that the Peoples acquisition had been completed on the day that the US went into COVID-19 lockdown. This was a catalyst for harmonising business practices across the two separate businesses in order to protect staff, and continue to deliver essential services. This has meant that corporate integration might be quicker than otherwise expected for the two companies.

COVID-19 pandemic related risks for US water and gas utilities

Essential Utilities is a stable company with regulated revenue base. However, it is not completely immune to the impending economic downturn. We highlight some of these risks as follows, how material they are, and discuss how the company is addressing and mitigating them.

- **Customer delinquencies:** Water and gas utilities are expected to experience an increase in customers being delinquent in paying their water bills. However, water utilities will have to continue to provide water to these delinquent customers rather than enact shut-offs. Hence, companies will incur additional costs.
- **Revenue shortfall:** US utilities are likely to experience some revenue shortfall due to declines in commercial, industrial, and institutional water consumption. This revenue shortfall may be offset by an increase in residential user charge revenue due to "stay-at-home" orders. Essential receives only 20% of its revenues from commercial and industrial customers. In April, according to management on the Q1 call, the company saw increased domestic demand from the shutdown offsetting much of the commercial and industrial volume reductions. The same principle applied in the Peoples business.
- **Reduced system development charges:** The COVID-19 crisis may slow the growth in new development and housing starts, which will impact the financial losses of water and gas utilities. A slowing of new customer growth would reduce new system development. Essential however, given its scale, still has growth from infrastructure rehabilitation for its existing customer rate base.
- **Increased personnel expenses:** There may well be some potential for additional costs associated with the pandemic such as for PPE. The company said during the Q1 that these expenses are relatively immaterial.
- **Delayed and reduced capital expenditures:** At Q1, management said only cUSD30m of project work had been delayed compared with its cUSD1bn of capital expenditure run rate.
- **Deferred water and gas rate increases:** Utilities may also experience future revenue losses as a result of deferrals of planned rate increases. These deferrals may exacerbate community economic impacts by further reducing utility capital spending and put the utility sector further behind in addressing its capital infrastructure needs. Essential has pending rate cases in Indiana, New Jersey, North Carolina, and Ohio, with total annualised revenue increase of USD10.1m. Rate cases appear to be proceeding on track and there is no indication of deferrals as yet. Given the rate cases proposed are relatively modest we do not see this as a risk.

Q1 2020 summary

Essential Utilities hosted a conference call for Q1 2020 earnings on 7 May 2020.

- Essential invested USD118.7m in the first three months. This does not include an additional USD53.5m that was invested by Peoples.
- It closed its acquisition of the water system of Campbell, Ohio; a utility with approximately 3,100 customer connections. For the quarter, customer growth for the company's water utilities totalled 0.6%, including organic growth.
- As a preventive measure to address liquidity concerns related to COVID-19 and its potential economic and capital markets impacts, the company secured and borrowed an additional USD500m on a 364-day term loan in early April 2020.

Outlook: FY2020 outlook reiterated

Essential reiterated its FY2020 outlook as follows:

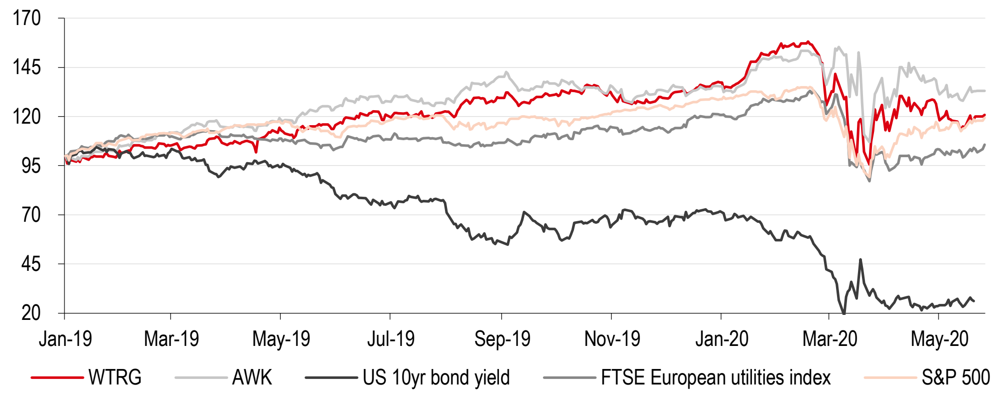
- Essential has signed purchase agreements for other municipal water and wastewater acquisitions that are expected to add the equivalent of over 205,000 water and wastewater retail customers, and approximately USD327m in expected rate base.
- Adjusted income per diluted common share (non-GAAP) of USD1.53 to USD1.58
- 2019-22e earnings CAGR of 5 to 7%
- Regulated water segment infrastructure investments of cUSD550m in 2020
- Regulated natural gas segment infrastructure investments of cUSD400m in 2020 on a full-year basis (adjusted to include capital invested in 2020 prior to Essential's ownership)
- Infrastructure investments of approximately USD2.8bn through 2022 in existing operations to rehabilitate and strengthen water, wastewater, and natural gas systems (including regulated natural gas segment capital invested in 2020 prior to Essential's ownership)
- 2019-22e regulated water segment rate base CAGR of 6% to 7%
- 2019-22e regulated natural gas segment rate base CAGR of 8 to 10%
- Total annual regulated water segment customer growth of between 2% and 3% on average depending upon regulatory approval
- Gas customer count expected to be relatively stable for 2020.

Performance against peers

Essential's share price has outperformed the S&P 500 by 2% since 1 January 2019. It is trading at a discount to its water peer group's 2020e PE, but in line with some of the US electricity utilities according to Refinitiv Datastream. This reflects, in our view, its multi-utility status.

The US Treasury 10-year yield has fallen sharply. WTRG, as a defensive utility, should be inversely correlated to bond yields.

WTRG vs AWK vs UST 10yr bond yield vs FTSE European utilities index vs S&P500



Source: Refinitiv Datastream

Credit metrics analysis

According to Moody's, WTRG needs to maintain its RCF/ net debt ratio in the range of 7%-14% and FFO/ net debt in the range of 11%-18% to maintain its Baa2 credit rating.

During the Q1 2020 conference call, Essential said that as the equity markets recover, the company will look for the appropriate time to issue approximately USD300m of equity in later 2020 or early 2021. That equity, as first mentioned on the Investor Day, is necessary to appropriately capitalise DELCORA and other acquisitions in the pipeline.

We have modelled for this equity issuance as well as completion of this acquisition in 2021. Given the increased equity, the company's credit metrics appear to remain in the target metric range for the current credit rating.

Credit metrics analysis

	2020e	2021e	2022e
RCF/ net debt	8.6%	8.5%	8.3%
FFO/ net debt	14.5%	14.3%	14.0%

Source: HSBC estimates

Change in estimates

We have updated our estimates post the Q1 2020 results posted on 7 May 2020. We have also updated our model for USD300m of equity offering, which has increased our number of shares outstanding and lowered our net debt assumptions for 2021e.

We continue to use pro-forma 2020 assumptions to smooth the effect of the costs and timing of the Peoples deal, excluding transaction costs and assuming the deal was completed to benefit from the gas heating season on a normalised weather basis. This is the basis on which Essential will report its underlying results.

Changes in estimates (USDm)

	2020e	2021e	2022e
EBIT			
Revised	578	646	701
Previous	585	631	689
Change	*-1%*	*2%*	*2%*
Net income			
Revised	394	438	469
Previous	397	426	461
Change	*-1%*	*3%*	*2%*
EPS (USD)			
Revised	1.55	1.67	1.79
Previous	1.56	1.68	1.81
Change	*-1%*	*0%*	*-1%*
DPS (USD)			
Revised	1.01	1.09	1.18
Previous	1.01	1.09	1.18
Change	*0%*	*0%*	*0%*

Source: HSBC estimates

Valuation and risks

We value Essential Utilities via three methodologies: DCF, dividend yield, and the average of PE multiple and rate-based valuations. Taking the average of the three approaches gives us our target price of USD50.00 (unchanged).

- Previously we had used a 3% risk-free rate, in line with the utility methodology set out in our report *European Utilities: The three Rs: Renewables, low rates and low risk* (20 February 2020). We now adopt the lower HSBC 2.5% set by our equity strategists (see *Cost of Equity*, 10 February 2020) and used for other US utilities under our coverage. Our equity risk premium and beta assumptions remain unchanged at 3% and 0.60, respectively. Our DCF valuation increases to USD50.0 (from USD41.1).
- In our PE multiple-based valuation, we maintain our target multiple in line with market peers, at 30.0x. We use a water peer group P/B of 2.4x (unchanged) as a proxy for a rate-based valuation. This is consistent with all US utilities under our coverage and is a proxy for EV. The average of the two declines to USD51.6 (from USD51.9), reflecting our updated estimates.
- For our Yield-based valuation, we increase our target yield to 2.13% from 1.75%, in line with its Water and Related Utilities peers. This results in a decreased Yield valuation of USD47.5 (from USD57.8).

Overall, these changes lead to an unchanged TP of USD50.00, which implies 21.0% upside; we reiterate our Buy rating as we believe the combination of regulated investment and earnings growth is attractive.

Summary of valuation (USD)

Particulars	New	Previous
Current price as on 26-May-20	**41.3**	**NA**
DCF (updated estimates lower risk-free rate	50.0	41.1
Yield 2.13% from 1.75% (sector average)	47.5	57.8
PE and rate-based (updated estimates)	51.6	51.9
Target price (average rounded)	**50.0**	**50.0**
Upside/ downside to target price	21.0%	NA
Rating	**Buy**	**Buy**

Source: HSBC estimates

WACC inputs and DCF valuation

WACC inputs		Equity Valuation	USDm
Cost of debt		**+ DCF value**	**16,221**
Pre-tax cost of debt	8.5%	+ ST marketable assets	0
Marginal tax rate	8.0%	+ Value of associates	0
Cost of equity		+ Other assets	878
Risk-free rate (previously 3%)	2.5%	**EV (asset side)**	**17,100**
Equity risk premium	3.0%	- Net debt (+ if Net cash)	(4,371)
Additional risk		- Quasi debt (pension)	0
Beta (unchanged)	**0.60**	- Value of minorities	0
Debt - 39%	7.8%	Total non-equity claims	(4,371)
Equity - 61%	4.8%	Value of equity	12,729
Cost of capital	**5.9%**	**Value per share (USD)**	**50.0**

Source: HSBC estimates

Multiples and rate base (EV) valuation

	2020e rate base
Regulated water	
Pennsylvania	3,682
Ohio	368
Illinois	382
Texas	319
New Jersey	214
North Carolina	245
Indiana	90
Virginia	83
Regulated gas	**2,451**
Total rate base	7,834
Rate-based valuation assuming 2.4x multiple, in line with sector average P/B	**18,802**
Non-regulated 2020 PE multiple	9
Net debt 2020e, pensions & Minority	(4,371)
Estimated equity value	14,440
Estimated equity value per share (USD)	**56.8**
PE Multiple valuation	
2020 earnings	1.55
2020 PE sector average	30.0
Value per share	**46.4**
Average of rate base valuation and PE multiple valuation	**51.6**

Source: HSBC estimates

Downside risks include:

Essential Utilities failing to achieve the desired rate case revisions and infrastructure surcharges; lacking organic growth from asset replacement; inability to take advantage of the Fair Market Value legislation opportunity; dividend growth at a lower rate than we assume; inability to gain the Fair Market Value premium required in the systems it wants to acquire in Pennsylvania. Its current acquisitions of systems – New Garden and Limerick – are facing challenges to the premium proposed by Aqua.

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), or strategist(s) who is(are) primarily responsible for this report, including any analyst(s) whose name(s) appear(s) as author of an individual section or sections of the report and any analyst(s) named as the covering analyst(s) of a subsidiary company in a sum-of-the-parts valuation certifies(y) that the opinion(s) on the subject security(ies) or issuer(s), any views or forecasts expressed in the section(s) of which such individual(s) is(are) named as author(s), and any other views or forecasts expressed herein, including any views expressed on the back page of the research report, accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Verity Mitchell and Adam Dickens

Important disclosures

Equities: Stock ratings and basis for financial analysis

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Rating distribution for long-term investment opportunities

As of 27 May 2020, the distribution of all independent ratings published by HSBC is as follows:

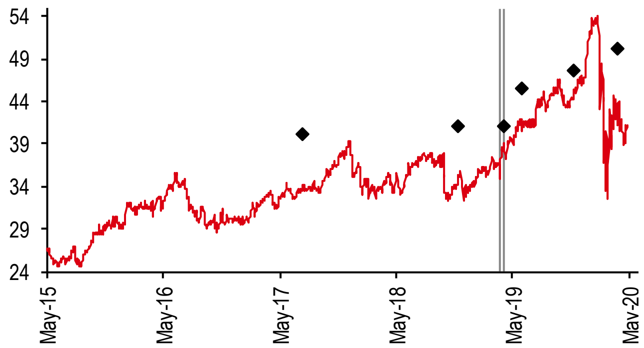
Buy	55%	(31% of these provided with Investment Banking Services)
Hold	37%	(31% of these provided with Investment Banking Services)
Sell	8%	(22% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

For the distribution of non-independent ratings published by HSBC, please see the disclosure page available at http://www.hsbcnet.com/gbm/financial-regulation/investment-recommendations-disclosures.

Share price and rating changes for long-term investment opportunities

Essential Utilities (WTRG.N) share price performance USD Vs HSBC rating history



Source: HSBC

Rating & target price history

From	To	Date	Analyst
Buy	Restricted	15 Apr 2019	
Restricted	Buy	30 Apr 2019	Verity Mitchell
Target price	**Value**	**Date**	**Analyst**
Price 1	40.00	08 Aug 2017	Verity Mitchell
Price 2	41.00	06 Dec 2018	Verity Mitchell
Price 3	Restricted	15 Apr 2019	
Price 4	41.00	30 Apr 2019	Verity Mitchell
Price 5	45.50	28 Jun 2019	Verity Mitchell
Price 6	47.50	06 Dec 2019	Verity Mitchell
Price 7	50.00	22 Apr 2020	Verity Mitchell

Source: HSBC

To view a list of all the independent fundamental ratings disseminated by HSBC during the preceding 12-month period, please use the following links to access the disclosure page:

Clients of Global Research and Global Banking and Markets: www.research.hsbc.com/A/Disclosures

Clients of HSBC Private Banking: www.research.privatebank.hsbc.com/Disclosures

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price date	Disclosure
ESSENTIAL UTILITIES	WTRG.N	41.31	26 May 2020	5, 6

Source: HSBC

1 HSBC has managed or co-managed a public offering of securities for this company within the past 12 months.

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